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## Research Update:

# Swedish Multi-Utility Kraftringen Energi Outlook Revised To Stable On Reduced Project Risk; 'BBB+/A-2' Ratings Affirmed

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## Research Update:

# Swedish Multi-Utility Kraftringen Energi Outlook Revised To Stable On Reduced Project Risk; 'BBB+/A-2' Ratings Affirmed

## Overview

- Kraftringen Energi's new combined heat and power plant, with a significant investment cost of SEK1.8 billion, is nearing completion, and we therefore assess that the company's project risk has decreased significantly.
- We also forecast that the commissioning of the plant will improve Kraftringen Energi's cash flows and credit metrics, owing to increased electricity production and decreased fuel costs.
- We are revising our outlook on Kraftringen to stable from negative and affirming our 'BBB+/A-2/K-1' ratings on the company.
- The stable outlook reflects our expectation that Kraftringen Energi's operating cash flows will continue to be supported by its regulated and stable electricity distribution operations and its relatively stable district heating operations.

## Rating Action

On Feb. 21, 2014, Standard & Poor's Ratings Services revised its outlook on Sweden-based multi-utility Kraftringen Energi AB (publ) to stable from negative. At the same time, we affirmed our 'BBB+' long-term and 'A-2' short-term corporate credit ratings, and the 'K-1' short-term Nordic scale ratings on Kraftringen Energi.

## Rationale

The outlook revision reflects our view that the near completion of the new combined heat and power (CHP) plant has significantly reduced Kraftringen Energi's project risk and execution risks. Kraftringen Energi's investment cost for the plant is significant, at about Swedish krona (SEK) 1.8 billion, and we understand the project has proceeded according to plan both in terms of timing and budget. We also forecast that the commissioning of the plant will support Kraftringen Energi's cash flows and gradually restore credit metrics, which have deteriorated due to the debt-funded investment.

We base our ratings on Kraftringen Energi on the company's stand-alone credit profile (SACP), which we assess at 'bbb-', reflecting its "satisfactory" business risk profile and "significant" financial risk profile. The long-term rating further includes two notches of uplift based on our opinion that there

is a "moderately high" likelihood that the Municipality of Lund (AAA/Stable/A-1+) would provide timely and sufficient extraordinary support to Kraftringen Energi in the event of financial distress.

In accordance with our criteria for government-related entities, our view that there is a "moderately high" likelihood of extraordinary support from the Municipality of Lund is based on our assessment of Kraftringen Energi's:

- "Strong" link to the municipality, primarily reflecting the municipality's 82% ownership through the holding company Kraftringen AB, in which the remaining shareholders are the municipalities of Eslöv (12%), Hörby (4%), and Lomma (2%). Kraftringen Energi's operations are strongly aligned with the interests of the four municipalities and, in particular, Lund, which has a strong affiliation with, and controlling influence over, the group; and
- "Important" role for Lund, given its focus on providing critical public services and contributing to Lund's environmental agenda.

Kraftringen Energi's "satisfactory" business risk profile reflects its operations in the regulated electricity distribution and stable district heating businesses, which make up approximately 70% of gross profit. It also reflects our assessment of the company's competitive position as "satisfactory," supported by our view of the regulatory framework for electricity distribution in Sweden as stable and predictable, despite some uncertainty regarding the ongoing legal dispute between the regulator and distribution service operators related to the revenue caps for the 2012-2015 regulatory period. We estimate, however, that the outcome of the dispute will not likely result in lower revenue caps than those originally assigned by the regulator. The competitive position is constrained by Kraftringen Energi's limited scale and diversity within the electricity distribution grid, given that it covers a relatively limited area, and that the company's district heating and electricity production businesses rely on a few key assets. This makes the company more vulnerable to any extraordinary weather conditions or operational difficulties.

Our assessment of Kraftringen Energi's financial risk profile as "significant" reflects the company's relatively high debt due to the significant debt-funded investment in the CHP plant, which has led to a temporarily deterioration of credit measures. We estimate that funds from operations (FFO) to debt at the end of 2013 amounted to about 15%. At the same time, we expect that the commissioning of the CHP plant will support cash flows as from this year, leading to an improvement in FFO to debt toward 20% within the next two years.

Our base case assumes:

- Increase in EBITDA by about SEK200 million between 2013 and 2015, as a result of increased electricity production and reduced fuels costs.
- Annual capital expenditures decreasing to about SEK350 million from 2015 onward, while dividends remain at their current level of SEK60 million. This would lead to positive discretionary cash flow for 2015.

Based on these assumptions, we arrive at the following credit measures for

2014 and 2015:

- FFO to debt of about 17%-20%.
- FFO cash interest coverage of about 5.0x-5.5x.

### **Liquidity**

We view Kraftringen Energi's liquidity position as "adequate" under our criteria. We believe that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should be in excess of 1.1x of forecast near-term cash outflows such as debt repayments, capital expenditures, and dividend payments. We also expect that sources will exceed uses even if EBITDA declines by 10%.

We further believe that the company has a sound relationship with its banks, a satisfactory standing in the credit markets, as evidenced by two bond issues in 2013, and prudent risk management.

### **Principal liquidity sources**

- SEK60 million in cash and cash equivalents as of Dec. 31, 2013;
- Access to SEK1 billion through two SEK500 million committed credit lines maturing in 2015-2016, used as backup financing for a SEK1 billion commercial paper program;
- Access to a total of SEK750 million through revolving credit facilities with three Nordic banks, SEK450 million of which matures in 2015 and SEK300 million in 2016; and
- Forecast FFO of about SEK470 million.

### **Principal liquidity uses**

- SEK60 million of forecast dividends annually;
- SEK560 million of forecast capital expenditures in 2014; and
- Debt maturities of SEK980 million in 2014, of which SEK880 million relates to commercial paper.

## **Outlook**

The stable outlook reflects our expectation that Kraftringen Energi's operating cash flows will continue to be supported by its regulated and stable electricity distribution operations and the relatively stable district heating operations. It further reflects our expectations of a gradual restoration of credit measures following the completion of the debt-funded CHP plant, including FFO to debt improving to about 20% over the next two years.

### **Downside scenario**

We could consider a negative rating action if credit measures did not improve according to our current forecasts, for example if FFO to debt stayed below 17%-18% for an extended period. This could result, for example, from any significant further debt-funded investment or operational underperformance. We could also lower the ratings if our assessment of the regulatory framework for either electricity distribution or district heating were to weaken. In addition, we could also lower the ratings if we lowered our assessment of the

likelihood of extraordinary support from the Municipality of Lund. This could result if Lund significantly diluted its ownership in the company.

### **Upside scenario**

We could consider an upgrade if Kraftringen Energi's financial position improved to a level we view as commensurate with an "intermediate" financial risk profile. This could result, all else being equal, if the company's FFO-to-debt ratio improved to about 28% on a sustainable basis.

## **Ratings Score Snapshot**

Corporate Credit Rating: BBB+/Stable/A-2

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

- Local government rating: AAA
- Likelihood of local government support: Moderately high (+2 notches)

## **Related Criteria And Research**

### **Related criteria**

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- 2008 Corporate Criteria: Commercial Paper, April 15, 2008

### Related research

- Country Risk Assessments Update: February, Feb. 11, 2014
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

## Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Kraftringen Energi AB (publ)		
Corporate Credit Rating	BBB+/Stable/A-2	BBB+/Negative/A-2
Nordic Regional Scale	--/--/K-1	--/--/K-1
Senior Unsecured	BBB+	BBB+
Commercial Paper	K-1	K-1

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